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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966.

No. 768

WILLIAM J. SULLIVAN AND
GEORGIA K. SULLIVAN,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

REPLY TO MEMORANDUM FOR RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

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PETITIONERS' REPLY

On November 14, 1966, the Petition for a Writ of Certiorari was filed which raised the question of what constitutes income under the Sixteenth Amendment. Over five months later, the respondent filed its memorandum in opposition. This is in reply to that memorandum.

Respondent does not contend that there is no Constitutional question, nor that this case does not warrant this Court's review. Indeed, respondent has conceded that the decision of the Court below produces a conflict between the Circuits, and urges only that the decisions below are

correct. Only this Court, however, determines conflicts between the Circuits—especially those involving Constitutional questions.

1. The decisions of the Courts below that there was income are erroneous.

First, the corporation did not pay petitioner a cash dividend, consequently respondent's analysis (pp. 3, 4) is irrelevant. Secondly, the corporation did not purchase property which petitioner received, pay any personal expenses of petitioner, or relieve him of a money debt for which he had previously received property or benefit. Consequently the principles and cases relied upon by respondent (p. 4, fn. 1) are not in point. Finally, the corporation did not purchase stock which the petitioner received—here the corporation redeemed its own stock and held it as treasury stock.

Respondent contends (p. 3) that "By directing his corporation to perform the contract in his place, petitioner ended up with $198,000.00 more cash in his pocket than if he had performed, * * *". Respondent necessarily assumes that petitioner had $198,000.00 before the transaction, and after the transaction had the same $198,000.00. Obviously, then, petitioner received no income—otherwise, he would have "ended up" with more than the original $198,000.00. Assume that before the transaction petitioner had cash of zero, his sole asset being the stock in the corporation. After the transaction petitioner would still have cash of zero and still have stock worth the same amount as before (about $300,000.00),[1] because of the corporate payout to redeem Nelson's stock. Plainly, petitioner received nothing.

1. For the sake of simplicity we are rounding the figures to even thousands, i.e., the corporation was worth $500,000.00, the payout to redeem Nelson's stock was $200,000.00, and petitioner's interest in the corporation was worth $300,000.00.

Assume that, as here, petitioner did not perform the contract but that it was performed by the corporation. The corporation, worth about $500,000.00 before the redemption, paid out $200,000.00 to Nelson. Petitioner's personal cash situation is unchanged. Moreover, the value of petitioner's stock interest in the corporation before and after the transaction is unchanged, as the parties herein stipulated (R. 154). Clearly if petitioner received no additional cash and the value of his stock did not increase—he received nothing of real financial or economic value. This is the precise holding of the Tax Court in *John A. Decker*, 32 T.C. 326 (1959), aff'd 286 F.2d 427 (C.A. 6th, 1960), at page 332 of its opinion.

Whether petitioner or the corporation purchased Nelson's stock makes no real financial or economic difference to any of the three parties involved in this transaction. Obviously, Nelson's position remains the same, whether petitioner or the corporation buys his stock. If petitioner purchases Nelson's stock, his financial position remains the same—he has merely exchanged one asset (cash) for another asset (stock) worth the same amount. The stock represents a claim on the corporate assets worth $200,000.00. If petitioner never disposed of Nelson's stock, his financial position with respect thereto remains in status quo. If upon purchase of Nelson's stock (paying out $200,000.00), petitioner liquidates the corporation (receiving liquidation proceeds of $500,000.00)—his financial position is the same; he "ends up" with a net of $300,000.00.

Contrariwise, assume that petitioner did not perform the contract, but that the corporation purchased Nelson's stock. As seen hereinabove, petitioner's financial position remains as it was before the transaction. If petitioner retains his stock, all he has is the worth of that stock before the transaction (about $300,000.00). If at the moment

after the corporation purchased Nelson's stock, the petitioner liquidated the corporation, all he could receive is about $300,000.00—the value of his stock before the transaction.

As urged at pages 22-26 of the petition, the subject transaction constituted not only a stock redemption by the corporation but also a partial liquidation and contraction of the corporation under Section 346(b) of the 1954 Code. Under such circumstances there is no practical difference whether the corporation redeems the stock, or whether the petitioner purchases the stock and sells it to the corporation, at the same price he paid. *John McShain*, T.C. Memo. 1963-306, 22 T.C.M. 1611, 1616. The purchase from Nelson would provide petitioner a basis in the stock of $200,000.00, if he sells the stock to the corporation for $200,000.00—because of the partial liquidation—the sale is a capital gain transaction under Section 346(b); however, there is no capital gain, and thus no tax consequences to petitioner.

Respondent's contention (p. 4) that if petitioner received some benefit from this transaction, the corporation incurred a detriment is erroneous. The redemption by a corporation of shares of its own stock which are held as treasury stock (as here) is like the acquisition of any other asset. *Commissioner of Internal Revenue* v. *Snite*, 177 F.2d 819, 822 (C.A. 7th, 1949); *Emeloid* v. *Commissioner of Internal Revenue*, 189 F.2d 230, 234 (C.A. 3rd, 1951). Moreover, it is elementary corporate law, that a corporation's stock represents an outstanding claim by the shareholders against the net assets of the corporation. It follows, that redemption by a corporation of outstanding shares of its stock reduces the claims against the corporation's assets. Many publicly-held corporations regularly redeem shares of their own stock. If this reduced the corporations' worth their shareholders could recover against the corporation's

directors. Such an action will not lie, however, since the rights of the shareholders are unaffected. Assume that there were other shareholders in the corporation with petitioner and Nelson. The worth of their stock would not have been diminished by the transaction between petitioner, Nelson, and the corporation. As a matter of "Hornbook Law" the corporation here incurred no detriment.

Thus, if petitioner performed the contract, he is not "worse off"; nor is the corporation if it performs the contract. Accordingly, this case is unlike those cases where a corporation pays out money, e.g., payment of a shareholder's fine or traffic ticket (for which it receives nothing)—and the shareholder is benefited because he did not have to pay out money for which he would have received nothing. It follows that petitioner cannot be benefited by the corporation's performance—nor the corporation's worth diminished thereby.

Respondent erroneously contends (p. 4) that petitioner's net worth, *apart* from the worth of his stock in the corporation, must be considered to determine whether he received income. Without exception, the Courts have considered the question of the shareholder's financial worth in relationship to the reduced value of his stock in the corporation.[2] The cases cited (p. 4, fn. 1) in support of respondent's theory of fragmented net worths are not in point. First, none of the cases disclose that respondent's net worth doctrine was considered or passed upon by the Courts. Secondly, none of the cases involved a stock redemption and partial liquidation. Thirdly, each case in-

2. *Ruben* v. *Commissioner of Internal Revenue*, 97 F.2d 926, 928 (C.C.A. 8th, 1938); *John A. Decker*, supra, pp. 332, 333; *Hargleroad* v. *U. S.*, 202 F. Supp. 92, 95 (D.C. Neb., 1962); *William Green*, T.C. Memo. 1963-248, 22 T.C.M. 1241, 1247 (1963); *John McShain*, supra, p. 1616; *Dwight Gahm*, T.C. Memo. 1964-118, 23 T.C.M. 665, 670; *William K. Edmister*, 46 T.C. 651, 662 (1966); *Frank Ciaio*, 47 T.C. 447, 458 (1967).

volved the corporation's payment of personal expenses of the shareholder, or the corporation purchased property which the shareholder received.

Respondent is concerned (p. 4) by the circumstance that petitioner owned all of the stock of the corporation after the transaction. First, from the standpoint of control, there is no practical difference between a shareholder owning 60% of the stock of a corporation and 100% thereof. Secondly, the parties stipulated that the value of petitioner's stock was the same before and after the redemption. Thirdly, the redemption by a corporation of one shareholder's stock cannot be treated as a dividened to the remaining shareholders merely because their percentage interests in the corporation are increased—indeed, to tax such an indirect benefit, is unconstitutional. *Holsey* v. *Commissioner*, 258 F.2d 865, 868 (C.A. 3rd, 1958). The Commissioner acquiesced to this precise holding in *Holsey*. Rev. Rul. 58-614, C.B. 1958-2, p. 920.

In the Petition for Certiorari, on the question of whether petitioner received income, it was contended that the conclusion of the Court below was in square conflict with *John A. Decker*, supra. The respondent filed applications for extension of time in this court wherein it was conceded that the result in this case is "apparently in conflict with *Decker* v. *Commissioner*, * * *". Now respondent seeks to distinguish *Decker* in contradiction to the position heretofore taken in pleadings filed with this Court. Moreover, the attempt to distinguish *Decker* is wholly without merit.

The sole ground for holding that petitioner received income is the conclusion of the Court below that he had an unconditional contract obligation which his corporation performed. In *Decker* the Court specifically held that the continuing shareholders had unconditional contract obliga-

tions—but that their performance by the corporation did not constitute income to the continuing shareholders. The two Circuits are in direct conflict on what constitutes "income". Thus is the Constitutional question framed.

Whether there was a corporate business purpose is not determinative of whether the continuing shareholder received income.[3] The real question is whether the shareholders received "some real financial or economic value".[4] Accordingly, on the Constitutional question, the judgment of the Court below is not only in square conflict with the Sixth Circuit in *Decker*, but also with the Third Circuit in *Schmitt* and *Holsey*, and the Ninth Circuit in *Niederkrome*.

The decisions of the lower Federal Courts are in hopeless confusion, which Congress attempted to resolve in the 1954 Code. It is evident that confusion and doubt persist. Nor is the Commissioner's view of the question marked by unswerving precision. The Sixth Circuit decided *Decker* in 1960. After a pause of four years, the Commissioner acquiesced therein in 1964 (1964-2, C.B. p. 5); and we are now advised by respondent (p. 7, fn. 4) that the Commissioner, seven years after *Decker*, is re-examining his acquiescence.

Petitioners urged (Pet., pp. 16, 17) respondent's admission on brief that the contract obligation assumed by the corporation was only conditional—not primary and un-

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3. *Daniel W. Northup* v. *United States*, 240 F.2d 304, 307 (C.A. 2nd, 1957); *Holsey* v. *Commissioner of Internal Revenue*, supra, p. 869; *Bradbury* v. *C.I.R.*, 298 F.2d 111, 117-118 (C.A. 1st, 1962); *Aloysius J. McGinty* v. *Commissioner*, 325 F.2d 820, 822 (C.A. 2nd, 1963); *Charles P. Hasbrook* v. *United States*, 343 F.2d 811, 814 (C.A. 2nd, 1965).

4. *Schmitt* v. *Commissioner*, 208 F.2d 819, 821 (C.A. 3rd, 1954); *Holsey* v. *Commissioner of Internal Revenue*, supra, p. 868; *Niederkrome* v. *Commissioner of Internal Revenue*, 266 F.2d 238, 243 (C.A. 9th, 1958).

conditional. (Undoubtedly respondent's admission was premised on the corporation's ratification and adoption of the contract *before* its execution by petitioner; and because the contract afforded petitioner an alternative method of performance—assignment to a third party.)

Respondent not only failed to respond to this allegation, but now contends that the contract allegation was unconditional. Again, it is elementary contract law that where the obligor has an alternative method of performance, the obligation is only conditional and akin to an option. Where the contract is an option or the obligation is only conditional, its performance by the corporation does not result in a dividend to the continuing shareholder.[5] If as respondent admitted, the contract obligation was only conditional, respondent's position herein results in grave injustice to petitioners. Moreover, respondent's position before this Court is erroneous as a matter of law and contrary to its published agreement with legal principles enunciated by the Courts. We do not suggest (and do not believe) that respondent's admissions in pleadings and briefs and its published rulings are not made in good faith. However, respondent's position herein is plagued with inconsistency. The resulting injustice to petitioners should be righted by respondent—or this Court. Moreover, if the Commissioner now changes his position in *Decker*, he should do so prospectively, not retrospectively.

2. We note that respondent's memorandum contains no response whatsover to petitioner's contention (pp. 16-22) that the result in this case is in conflict with the rule of substance versus form. We recognize respondent's reply on the parol evidence question which, however, is only collateral to the substance versus form principle.

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5. See case citations and commissioner's acquiescences, p. 17, Petition for Certiorari.

3. Petitioners contended (pp. 22-27) that the subject transaction constituted not only a stock redemption but also a partial liquidation under Section 346(b) of the 1954 Code. Respondent seems to suggest (p. 10) that this means the distribution qualifies for capital gain treatment. Petitioners made no such contention. Rather, petitioners urged that since the subject stock redemption also constitutes a partial liquidation under Section 346(b), the distribution is governed by Section 331. That statute, and the Commissioner's own regulations, specifically prohibit dividend treatment of any distribution falling under Section 346. Thus the determination of the Court below is erroneous as a matter of law, and is in direct conflict with Congressional Intent as reflected in Sections 346 and 331.

In opposing Section 346 treatment, respondent's sole contention is that the distribution was not attributable to the corporation's ceasing to conduct a business because the distribution was made before the corporation decided to sell its automobile dealership. This is plain error. The corporation decided to sell its automobile dealership at least as early as March 9, 1956 at a stockholder's meeting (R. 101, 102). The corporation's dealership assets were sold in April, 1956 (R. 81). The stock redemption was not consummated until May 1, 1956 (R. 109, 114).

There is no factual dispute—the only question is one of statutory construction. The failure of the Court below to decide this issue requires this Court's supervision.

The petition for certiorari should be granted by this Court.

Respectfully submitted,

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